

Auditing Guidance Statement

AGS 1058
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Auditing Mortgage Investment Schemes

Prepared by the **Auditing & Assurance Standards Board** of the
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AGS 1058 “AUDITING MORTGAGE INVESTMENT
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Introduction

- .01 This Auditing Guidance Statement (AGS) has been prepared by the Auditing & Assurance Standards Board (AuASB) to provide general guidance to auditors of mortgage investment schemes which are regulated by the Australian Securities & Investments Commission (ASIC) and are subject to Chapter 5C of the *Corporations Act 2001* (Cth) (the “Act”). The guidance in this AGS should be read in conjunction with that contained in AGS 1052 “Special Considerations in the Audit of Compliance Plans of Managed Investment Schemes” for audits of mortgage investment schemes compliance plans undertaken pursuant to section 601HG of the Act.
- .02 Auditors of mortgage investment schemes are required to adhere to the basic principles and essential procedures contained in Auditing Standards (AUSs). This AGS has been developed to clarify auditors’ responsibilities in respect of such engagements, and to provide guidance to the auditors on additional considerations which may be taken into account when undertaking financial report and compliance plan audits of mortgage investment schemes.
- .03 It is important to note that this AGS does not impose any responsibilities on the auditor beyond those which are imposed by AUSs and the requirements of the Act. The provisions of the Act in this area are supported by ASIC Policy Statement 144 “Mortgage Investment Schemes” and other ASIC policy statements, including those applicable to managed investment schemes, as well as modifications to the Act made by individual orders or class orders issued by ASIC.

Regulatory Background

ASIC Policy Statement 144

- .04 In the past, ASIC provided class order exemptions for mortgage schemes operated by solicitors and finance brokers in most States and Territories. These exemptions meant that mortgage investment scheme operators did not have to comply with the provisions of the Act dealing with prospectuses, sharehawking, approved deeds and securities licensing.
- .05 After a detailed review of the mortgage investment industry by ASIC, it was decided to change the manner in which mortgage investment schemes are regulated, and in July 1999, ASIC issued Interim Policy Statement PS 144 “Mortgage Investment Schemes”. PS 144 was subsequently revised and re-issued as a final ASIC Policy Statement in March 2000.

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- .06 ASIC’s regulatory framework for mortgage investment schemes principally consists of:
- (a) a requirement for operators of mortgage schemes that meet the criteria for registration as a managed investment scheme to comply with Chapter 5C of the Act;
 - (b) application of PS 144, as well as other relevant ASIC policy statements applicable to managed investment schemes generally; and
 - (c) the provision of relief by ASIC specific to mortgage scheme operators in certain cases. Operators of small, low risk schemes e.g. solicitors’ mortgage practices, may be permitted to comply with an approved industry body’s rules (for example, those of the relevant State and Territory professional law bodies) rather than all of Chapter 5C, if the body can demonstrate effective supervision over such participants.¹
- .07 Under PS 144 a mortgage investment scheme would, *prima facie*, be regarded as being a managed investment scheme if:
- (a) the legal or commercial character of the investment is determined by the nature of the business operations of the promoter e.g. where money contributed by different investors is lent under one mortgage; and
 - (b) commercial decisions are taken by the operator or the promoter of the scheme and not by investors.
- .08 PS 144 recognises that section 601ED must also be satisfied to enable a mortgage investment scheme to be registered as a managed investment scheme under Chapter 5C. The basic requirements of this section are that:
- (a) the scheme must have more than 20 members (investors);
or

¹ For schemes of this kind with no more than 20 investors and no more than \$7.5 million in total loan capital, ASIC is prepared to allow such operators to participate in an industry based compliance structure approved by ASIC. However, ASIC has indicated that it will impose various conditions on such schemes, including the requirement for the application prospectus disclosure and the securities hawking provisions of the law.

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- (b) the scheme was promoted by a person, or an associate of a person, who was, when the scheme was promoted, in the business of promoting managed investment schemes; or
- (c) ASIC has determined that a number of schemes are closely related and that each of them has to be registered as their total number of members is greater than 20.²

Responsibilities of Management and Auditors

Management’s Responsibilities

- .09 Section 285 imposes a responsibility on registered schemes, which by virtue of PS 144 includes mortgage investment schemes, to comply with the requirements of Chapter 2M of the Act dealing with financial reports and audit requirements. Furthermore, section 285(3) deems a scheme’s responsible entity responsible for the performance of the financial reporting obligations in that Chapter in respect of the scheme.
- .10 In addition to the above obligations, the responsible entity of a scheme is required to comply with Part 5C.4 of the Act and ASIC Policy Statement 132 “Managed investments: Compliance plans”. These requirements impose obligations on the responsible entity to ensure that compliance plans are in place which set out adequate measures that the responsible entity is to apply in operating the scheme to ensure compliance with the Act and the scheme’s constitution.
- .11 As with managed investment schemes generally, the responsible entity of a mortgage investment scheme which is registered under section 601ED, will be completely liable to the members of the scheme for all aspects of the operation of the scheme.³ To this end, the responsible entity and the directors of that entity, are responsible to the members of the scheme for the operation of the scheme, for meeting its statutory and other legal obligations, and for having in place and maintaining an adequate system of internal control to protect the interests of members who have invested in the scheme.
- .12 A scheme’s internal control structure is to provide its management, viz. the responsible entity, with reasonable, but not absolute

² Auditors of smaller schemes not directly regulated by ASIC but administered as part of an industry based compliance structure may also be required to report on various compliance matters as part of the auditing arrangements which are agreed to with the individual State or Territory industry supervisory bodies.

³ See *Explanatory Memorandum*, Managed Investments Bill 1997, p 8.

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assurance, that the operations of the scheme are orderly and efficient, and that irregularities are prevented as far as possible and detected should they occur. An adequate internal control system will also provide management with reasonable assurance that assets are safeguarded from unauthorised use or disposal, and that the financial and other records of the scheme reflect the entire operational activities of the scheme and permit the timely preparation of financial reports required by the Act.

Auditors’ Responsibilities

- .13 The auditor of a scheme’s financial report ordinarily obtains a preliminary understanding of the scheme’s internal control structure, assesses the level of control risk, and where appropriate, tests the effectiveness of internal controls and other compliance measures in the context of the scope of the audit of the scheme’s financial report audit, in order to be able to form an opinion on it as required by Chapter 2M.⁴
- .14 Similarly, the compliance plan auditor who conducts the audit of a scheme’s compliance plan under section 601HG, also needs to understand and assess internal controls within the scope of such an engagement, and be mindful of the compliance related requirements imposed on such schemes by PS 144 and the other relevant ASIC policy statements, including those policy statements applicable to managed investment schemes generally. This is so, notwithstanding that the compliance plan audit and the financial report audit are separate engagements.⁵

Agreeing on the Terms of the Audit Engagements

- .15 Under section 331AB, the scheme’s responsible entity is responsible for the appointment of the scheme’s financial report auditor. This is also the case for the scheme’s compliance plan auditor who is appointed by the responsible entity under section 601HG. It is therefore essential that the auditors and the scheme’s responsible entity separately agree on the terms of the respective audit engagements, which are to be recorded in writing. Such terms are

⁴ See AUS 402 “Risk Assessments and Internal Controls”.

⁵ Under section 601HG(2) the compliance plan auditor and the financial report auditor of the responsible entity must be different persons, notwithstanding that they may be from the same firm. See also AGS 1052 “Special Considerations in the Audit of Managed Investment Schemes” para.18.

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normally outlined in separate audit engagement letters which are forwarded to the responsible entity.⁶

- .16 The auditors may use the engagement letters to clarify the respective roles of the responsible entity’s directors, the financial report auditor and the compliance plan auditor, by contrasting the respective statutory responsibilities of the responsible entity and the auditors under the Act. Both the financial report auditor and compliance plan auditor obtain acknowledgment of management’s responsibilities from the directors of the scheme’s responsible entity when obtaining agreement on the terms of the audit engagements.

Issues for Auditors to Consider

- .17 In addition to the issues normally considered when undertaking financial report audits and compliance plan audits, auditors of mortgage investment schemes will need to consider several matters that are particularly important to the operation of such schemes. These matters include whether:
- (a) appropriate documentation is available in respect of all deposits or receipts to the scheme and its bank accounts, and in relation to payments and withdrawals from the scheme and its bank accounts;
 - (b) appropriate documentation is available in respect of all loans made by the scheme e.g. detailed loan agreements, securities held, guarantees, terms of repayments, external independent valuations; and
 - (c) the mortgage investment scheme meets the solvency requirements prescribed by ASIC and that its basis of reporting is consistent with it continuing to operate as a going concern over the relevant period.
- .18 The auditors of the mortgage investment schemes may also take into account other specific compliance related considerations relevant to such schemes. These considerations include whether:
- (a) investor funds have been placed in the mortgage investment scheme on the basis of the written approval of the investor;

⁶ Or other suitable form of audit contract. See AUS 204 “Terms of Audit Engagements”.

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- (b) specific disbursements of investor funds are supported by written authorities from investors;
- (c) investor funds are capable of being remitted back to the investor within the time period specified by the investor and that the net monies loaned (after agents commission/loan establishment fees) are sufficient;
- (d) investors funds have been appropriately secured e.g. first mortgages or other charges or liens are taken out over the assets and undertakings of the investee or borrower;
- (e) commissions or loan establishment fees paid to agents are in accordance with legally binding agreements between the parties;
- (f) interest and principal payments from the investee or borrower are being received in accordance with loan agreements;
- (g) interest paid to the investors is financed from receipt of investee or borrowers funds and not from the commissions or other monies due to solicitors or agents;
- (h) periodic statements are provided to investors in respect of the disbursement of their funds until the funds are fully utilised in mortgage investment scheme; and
- (i) that monthly bank reconciliations have been prepared in respect of each “trust” account.

.19 It is important that auditors take the above considerations into account when planning and undertaking both financial report audits and compliance plan audits of mortgage investment schemes. While not purporting to be an exhaustive list of compliance matters to be considered by auditors, they represent areas in which there should be appropriate controls in place, so as to adequately mitigate the risk of a material misstatement in a scheme’s financial report and/or material non-compliance with a scheme’s compliance plan.

Operative Date

.20 This AGS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AGS 1058 supersedes AGS 1058 “Auditing Mortgage Investment Schemes”, as issued in August 2001.

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Compatibility with International Standards and Statements on Auditing

- .21 There is no corresponding International Standard or Statement on Auditing.